Stanhope Capital Fortnightly Bulletin

Period ending 15 February 2018

Tactical Positioning

In our 'flash bulletin' dated 7th February, we pointed out that there had been an extreme movement in the VIX on the 5th February, hitting a level of 37 (the biggest ever one day movement). The VIX is used as an indicator of how much hedging activity is taking place in the U.S equity market. A high VIX reading suggests increased hedging activity. A low VIX is seen as reflecting investor complacency, with limited hedging action. For most of the last couple of years the VIX has traded in a low, narrow range of 10 to 15.

The sudden move in the VIX seemed to have the characteristics of a 'flash crash' that can reverse just as rapidly, and it is perhaps that notion that has allowed equity markets to recover over recent days. Equity investors are always keen to 'diagnose' market events and perhaps a 'flash crash' is a neat label. That said, higher levels of equity market volatility seem far more likely as investors adjust to a little more inflation.

Market Moves

	Equities (Local Currency, incl. Dividends)						
15-Feb-18	**World**	**US**	**Europe[1]**	**UK**	**Japan**	**GEM**	**Asia**
Last 2 Weeks	-3.7%	-3.2%	-4.7%	-3.6%	-6.0%	-3.8%	-4.2%
Year to Date	0.3%	2.3%	-2.6%	-5.5%	-4.7%	2.7%	1.0%

	Commodities			Currencies (vs. USD)			Gov't
	BCOM	**Gold**	**WTI Oil**	**EUR**	**GBP**	**JPY**	**UST 10Y[2]**
Last 2 Weeks	-1.7%	0.6%	-5.2%	0.7%	-0.6%	2.9%	+20 bps
Year to Date	0.3%	3.9%	1.5%	4.2%	4.3%	6.2%	+50 bps

[1] Europe excluding UK

[2] US Treasury 10 Year Yield shows absolute, not percentage, change in yield

Source: Bloomberg

The period was marked by a significant sell-off in equities and bonds owing to an unexpectedly sharp rise in US wages. This inflationary signal took no prisoners with all major regions seeing equity market declines; even Emerging Markets were not immune as the US dollar recovered slightly, albeit briefly. Whilst market expectations for interest rate rises have been creeping higher in the US since late-2016, buoyed by the gradual global economic recovery, it is the potential *speed* of these rises which spooked markets – a reaction reminiscent of the 'taper tantrum' days of 2013. However, more recently equities have bounced back convincingly, though still ending the period in negative territory.

US bond yields rose as higher inflation expectations in the US threatened interest rate rises. European bond yields also rose with consensus growing for the 10-year German benchmark to end 2018 at yields of over 1%.

At the end of the period, on 14th February ❤, headline US CPI (inflation) came in above expectations, at +0.5% vs. +0.3%, putting further upward pressure on bond yields (10 year yields rose 7.3bps on the day). However, this was, largely ignored by the equity market: whilst equity markets initially fell on the news, they then continued their recovery unabated. Upward moves were led, in the US, by banks, technology and energy stocks, supported both in the US and Europe by solid corporate results and reassuring GDP data.

The Japanese yen rose over the period, buttressed by reports that Bank of Japan Governor, Haruhiko Kuroda, will be reappointed for another term and Japanese Finance Minister, Taro Aso's, assertion that the currency is neither "excessively high nor low to the level that requires currency intervention". The currency is up some 6.2% vs. the US dollar so far this year as the need for safety has outweighed the promise of rising US interest rates. Year to date, we note that the US dollar has also been subject to downward pressure from a high, and increasing, US Federal budget deficit.

Oil prices fell during the period, having seen a dramatic pullback to 9th February (down 10% from the month's high point on 1st February). Prices have been depressed by the now consensus view (backed by the International Energy Agency ["IEA"] and OPEC) that the rise in global production in 2018 is likely to outpace the growth in demand. The US is likely to become the world's largest oil producer by 2019 and this will weaken the efficacy of price support by OPEC and Russia. In addition, Baker Hughes' US rig count posted its biggest weekly increase in a year and Iran's deputy oil minister has said he is looking to increase oil production by 700k barrels a day over the coming years. Whilst oil price weakness will not be an overall determinant of inflation past the short-term, it may reduce pressure on policy makers, to raise interest rates.

Gold has benefited from demand ahead of the Chinese New Year, supported by the falling dollar, and the jump in US CPI. Interestingly, it hasn't been a big beneficiary of the recent increase in volatility, as it fell slightly amidst the equity market falls.

Economic Updates

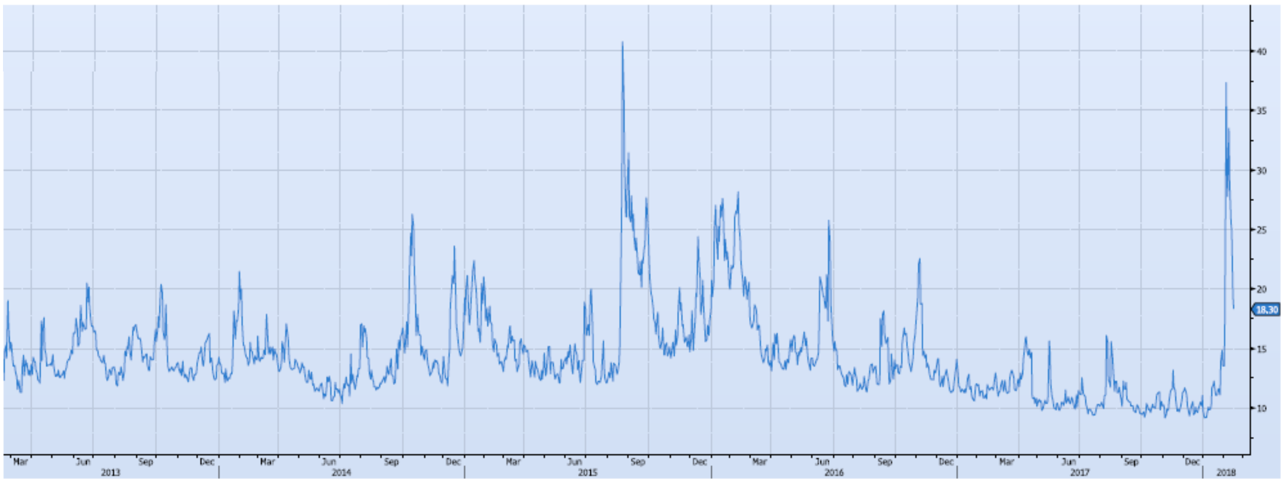
As mentioned above, equity market volatility was triggered by the increase in average hourly earnings growth in the US to 2.9% year-on-year, the highest rate since May 2009, whilst jobless claims in the US fell unexpectedly to their lowest level in 45 years. As highlighted above, the recent US CPI reading was above expectations and it is worth noting some of the finer details; the reading, of +0.35% for core CPI (vs. the expected +0.2%) is the highest monthly climb since March 2005, producing the highest six-month annualised rate since 2008 (+2.6%). However, underlying the figure, retail sales disappointed, reflecting poorly on the consumer environment in the US. With the Federal Reserve's five-year forward inflation gauge rising sharply – even before we begin to feel the impact of the recent tax reforms and planned infrastructure spend – it is perhaps comforting to see consumers (and oil) a little cooler, particularly when taking into account President Trump's recently announced, 2019 federal budget plans. Also, in the US, a Government shutdown (another one) was averted (again), service activity rose at its fastest pace in 12.5 years in January, and US core PPI also beat expectations, coming in at +0.4% month-on-month versus +0.2% expected.

We have seen more positive data out of the Eurozone: growth in 2017 was the strongest since 2007, at +2.5%; the growth forecast for 2018 has been raised by the European Commission to +2.3%; activity, as measured by the PMI, accelerated at its fastest pace in more than 10 years in January; both Italy and France's December industrial production came in above expectations at +4.9% and +4.5% apiece year-on-year; and Portugal's unemployment rate fell below 8% in December for the first time in 13 years. The UK, meanwhile, has seen no growth in industrial production year-on-year, alongside a widening trade deficit, now at -£4.9bn, as imports rose faster than exports. Nonetheless, the Bank of England's 2019 GDP forecast remains steady at +1.7% (and +1.8% in 2018).

Japan, which saw manufacturing PMI rise at the fastest pace in almost four years in January, has now seen growth for eight straight quarters, the longest run in 28 years, although growth in Q4 2017 was below forecasts (+0.5% annualised vs. consensus +1.0%). The disappointing end to last year may be an early sign of a breakdown in global growth synchronisation and is likely, in conjunction with currency strength, to be behind the weak performance of Japanese equities in the recent setback.

Last, but not least, we return to the VIX volatility – aka "fear" – index. Currently embroiled in a LIBOR-esque scandal (an anonymous whistle-blower has claimed the index has been manipulated higher by rogue option market makers). Whilst the VIX didn't manage to meet the levels seen in 2015 (let alone 2011 and 2008) it is likely that volatility will continue to be a feature of markets in 2018.

SPX Volatility Index over 5 Years



Source: Bloomberg

JONATHAN BELL
IVO COULSON
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15 February 2018

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